THE PRINCETON REVIEW, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements – (Continued)

9. Income Taxes

The (provision) benefit for income taxes consists of the following:

	Years Ended December 31,		
	2004	2003	2002
		(in thousands)	
Current tax (provision) benefit:			
U.S. Federal	—	$ (112)	—
State	—	(67)	—
Foreign	—	—	$ (67)
	—	(179)	(67)
Deferred tax (provision) benefit:			
U.S. Federal	$ (14,832)	(2,217)	575
State	(1,859)	(857)	228
Foreign	(16)	97	—
	(16,707)	(2,977)	803
Total (provision) benefit for income taxes	$ (16,707)	$ (3,156)	$ 736

Significant components of the Company's deferred tax assets and liabilities are as follows at:

	December 31,	
	2004	2003
	(in thousands)	
Deferred tax assets:		
Net operating loss carryforward	$ 20,764	$ 18,108
Tax credit carryforwards	85	112
Allowance for doubtful accounts	522	126
Equity compensation	187	186
Capitalized inventory costs	46	39
Deferred rent	574	500
Unrealized losses	147	162
Accumulated amortization including writedown of intangibles	1,368	—
Other	401	341
Total deferred tax assets	24,094	19,574
Deferred tax liabilities:		
Software development costs	(1,155)	(1,140)
Accumulated amortization	—	(1,310)
Accumulated depreciation	(807)	(460)
Total deferred tax liabilities	(1,962)	(2,910)
Net deferred tax assets before valuation allowance	22,132	16,664
Valuation allowance	(22,132)	—
Net deferred tax assets	$ —	$ 16,664

The net deferred income tax asset decreased from an asset of $16.7 million at December 31, 2003, to $0 at December 31, 2004. The $16.7 million change in the net deferred tax balance is primarily attributable to the establishment of a valuation allowance on the net deferred tax asset. The net deferred tax asset at December 31, 2003 is classified in the Company's consolidated balance sheet as other

current assets of approximately $852,000, and noncurrent deferred tax assets of approximately $15.8 million. As of December 31, 2004, the Company has a net operating loss carryforward totaling approximately $49.6 million which expires in the years 2020 through 2024, and other timing differences which will be available to offset regular taxable income during the carryforward period.

Deferred Tax Valuation Allowance

SFAS No. 109, *"Accounting for Income Taxes"*, requires that a valuation allowance be established when it is more likely than not that all or a portion of a deferred tax asset will not be realized. The cumulative pre-tax loss of $7.2 million incurred in the most recent three years represents sufficient negative evidence under the provisions of SFAS No. 109 for the Company to determine that the establishment of a full valuation allowance against the deferred tax asset is appropriate. This valuation allowance will offset assets associated with future tax deductions as well as carryforward items. Although management expects that these assets will ultimately be fully utilized, future performance cannot be assured.

A reconciliation setting forth the differences between the effective tax rate of the Company for the years ended December 31, 2004, 2003 and 2002 and the U.S. federal statutory tax rate is as follows:

	Years Ended December 31,					
	2004		2003		2002	
			(in thousands)			
U.S. Federal income tax benefit (provision) expenses at statutory rate	$ 4,660	34%	$ (2,537)	34%	$ 621	34%
Effect of permanent differences and other	39	0.3%	(121)	(1.5)%	(14)	(0.7)%
Effect of state taxes	726	5.3%	(498)	6.7%	129	7.1%
Valuation allowance	(22,132)	(161.5)%	—	— %	—	— %
	$ (16,707)	121.9%	$ (3,156)	42.2%	$ 736	40.4%

10. Employee Benefits and Contracts

Retirement Plan

The Company has a defined contribution plan (the "Plan") under Section 401(k) of the Internal Revenue Code, which provides that eligible employees may make contributions subject to Internal Revenue Code limitations. Employees become eligible to participate in the Plan on the first day of the quarter following the beginning of their full-time employment, but company matching contributions do not begin until one year after full-time employment. Under the provisions of the Plan, contributions made by the Company are discretionary and are determined annually by the trustees of the Plan. The Company's contributions to the Plan for the years ended December 31, 2004, 2003 and 2002 were $230,000, $200,000, and $199,000, respectively.

Stock Incentive Plan

On April 1, 2000, the Company adopted its 2000 Stock Incentive Plan (the "Stock Incentive Plan") providing for the authorization and issuance of up to 2,538,000 shares of common stock, as adjusted. In June 2000, June 2001, March 2003 and December 2004, an additional 211,500, 846,000, 1,000,000 and 308,085 shares, respectively, were authorized. The Stock Incentive Plan provides for the granting of incentive stock options, non-qualified stock options, restricted stock and deferred stock to eligible participants. Options granted under the Stock Incentive Plan are for periods not to exceed ten years. Other than for options to purchase 133,445 shares granted in 2000 to certain employees which were vested immediately, options outstanding under the Stock Incentive Plan generally vest quarterly over two to four years. As of December 31, 2004, there were approximately 335,000 shares available for grant.

THE PRINCETON REVIEW, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements – (Continued)

A summary of the activity of the Stock Incentive Plan is as follows:

	Options	Weighted-Average Exercise Price
Outstanding at December 31, 2001	**1,856,904**	$ 6.98
Granted at Market	769,050	7.94
Forfeited	(172,321)	6.75
Exercised	(40,271)	6.59
Outstanding at December 31, 2002	**2,413,362**	7.32
Granted at Market	429,236	4.63
Forfeited	(170,330)	7.79
Exercised	(124,205)	4.69
Outstanding at December 31, 2003	**2,548,063**	6.96
Granted at Market	1,098,473	7.48
Forfeited	(167,107)	7.60
Exercised	(120,926)	6.19
Outstanding at December 31, 2004	**3,358,503**	7.13
Exercisable At December 31, 2002	1,238,493	
Exercisable At December 31, 2003	1,790,513	
Exercisable At December 31, 2004	2,134,059	

Stock options outstanding at December 31, 2004 are summarized as follows:

	Options Outstanding			Options Exercisable	
Exercise Price	Options Outstanding	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price	Options Exercisable	Weighted Average Exercise Price
$1.73 - $2.30	99,904	5.25	$ 1.86	99,904	$ 1.86
$2.31 - $7.30	896,539	8.61	$ 6.04	394,774	$ 5.08
$7.31 - $7.39	1,084,658	5.58	$ 7.38	1,002,408	$ 7.39
$7.45 - $8.30	1,051,911	8.25	$ 7.80	449,049	$ 7.87
$8.31 - $11.00	225,491	6.45	$ 9.40	187,924	$ 9.52
	3,358,503	7.27	$ 7.13	2,134,059	$ 6.99

During 2001, the Company granted 116,500 stock options to non-employee advisors and, using the fair value method, recorded compensation expense of approximately $98,000, $151,000 and $256,000 for the years ended December 31, 2004, 2003 and 2002, respectively.

11. Related Parties

Publisher

Random House, Inc., a holder of 1,515,353 shares of the Company's common stock at December 31, 2004, is also the publisher and distributor of substantially all of the Company's books. For the years ended December 31, 2004, 2003 and 2002, the Company earned $3.8, $3.6 and $3.5 million respectively, of book and publication income from Random House, Inc. Total receivables at December 31, 2004 and 2003 included $2.8 and $2.4 million, respectively, due from Random House, Inc. for royalties, book advances, copy editing and marketing fees. In addition, Random House, Inc. has paid advances of $0 and $48,000, respectively, to the Company for books that have not yet been completed as of December 31, 2004 and 2003, which are deferred as book advances. At December 31, 2002, the Company had a liability to Random House, Inc. of $141,000 for advances.

Loans to Officers

As of December 31, 2004 and 2003 the Company had loans to two executive officers of approximately $1.3 million and $1.2 million, respectively. No loans were made to executive officers after February 2002, although interest continues to accrue. Such amounts and accrued interest are included in "Other Current Assets" and "Other assets" at December 31, 2004 and December 31, 2003. These loans are payable in four consecutive, equal annual installments with the first payment to be made on the earlier of the fourth anniversary of the loan or 60 days after termination of employment, accrue interest at 7.3% per year and, as of December 31, 2004, are secured by the 299,066 shares of the Company's common stock owned by these officers.

12. Acquisitions

On July 11, 2003, the Company acquired a 77% interest in Princeton Review of North Carolina, Inc. and the remaining 23% was acquired on November 13, 2003. The total purchase price including both transactions was approximately $1,138,000, including imputed interest. The purchase price exceeded the fair value of the net assets acquired resulting in goodwill of approximately $938,000. Princeton Review of North Carolina, Inc. provided test preparation courses in North Carolina under the Princeton Review name through a franchise agreement with the Company. This acquisition has been accounted for as a purchase and has been included in the Company's operations from the date of the purchase.

Approximately $170,000 of the purchase price was paid in cash at the time of closings. The remaining approximately $968,000 of the purchase price was paid by delivery to the sellers of subordinated promissory notes (see Note 6).

The pro forma effect of Princeton Review of North Carolina, Inc. is not presented because its results are not significant.

13. Segment Reporting

The operating segments reported below are the segments of the Company for which separate financial information is available and for which operating results as measured by EBITDA are evaluated regularly by executive management in deciding how to allocate resources and in assessing performance. The accounting policies of the business segments are the same as those described in the summary of significant accounting policies (see Note 1).

The following segment results include the allocation of certain information technology costs, accounting services, executive management costs, office facilities expenses, human resources expenses and other shared services which are allocated based on consumption. Corporate consists of unallocated administrative support functions. The Company operates its business through three divisions. The majority of the Company's revenue is earned by the Test Preparation Services division, which sells a range of services including test preparation, tutoring and academic counseling. Test Preparation Services derives its revenue from Company operated locations and from royalties from and product sales to independently owned franchises. The Admissions Services division earns revenue from subscription, transaction and marketing fees from higher education institutions and from selling advertising and sponsorships. The K-12 Services division earns fees from assessment, remediation and professional development services it renders to K-12 schools and from its content development work. Additionally, each division earns royalties and other fees from sales of its books published by Random House.

The segment results include EBITDA for the periods indicated. As used in this report, EBITDA means earnings before interest, income taxes, depreciation and amortization. The Company believes that EBITDA, a non-GAAP financial measure, represents a useful measure of evaluating its financial performance because it reflects earnings trends without the impact of certain non-cash and non-operations-related charges or income. The Company's management uses EBITDA to measure the operating profits or losses of the business. Analysts, investors and rating agencies frequently use EBITDA in the evaluation of companies, but the Company's presentation of EBITDA is not necessarily comparable to other similarly titled measures of other companies because of potential inconsistencies in the method of calculation. EBITDA is not intended as an alternative to net income as an indicator of the Company's operating performance, nor as an alternative to any other measure of performance calculated in conformity with GAAP.

	Year Ended December 31, 2004 (in thousands)				
	Test Preparation Services	K-12 Services	Admission Services	Corporate	Total
Revenue	$ 74,744	$ 27,957	$ 11,084	—	$ 113,785
Operating Expenses (including depreciation and amortization)	$ 42,858	$ 17,526	$ 21,813	$ 4,383	$ 86,580
Segment operating income (loss)	7,725	(3,608)	(14,372)	(3,193)	(13,448)
Depreciation & Amortization	1,804	2,161	1,898	1,139	7,002
Other	—	—	(67)	171	104
Segment EBITDA	$ 9,529	$ (1,447)	$ (12,541)	$ (1,883)	$ (6,342)
Total Segment Assets	$ 29,529	$ 21,867	$ 17,532	$ 38,713	$ 107,641
Segment Goodwill	$ 23,121	—	$ 500	$ 7,890	$ 31,511
Expenditures for long lived assets	$ 2,551	$ 3,385	$ 427	$ 2,639	$ 9,002

THE PRINCETON REVIEW, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements – (Continued)

	Year Ended December 31, 2003 (in thousands)				
	Test Preparation Services	K-12 Services	Admission Services	Corporate	Total
Revenue	$ 71,719	$ 21,525	$ 11,218	—	$ 104,462
Operating Expenses (including depreciation and amortization)	$ 39,123	$ 13,986	$ 10,822	$ 1,703	$ 65,634
Segment operating income (loss)	11,787	(789)	(2,440)	(1,703)	6,855
Depreciation & Amortization	1,522	1,594	1,760	1,161	6,037
Other	—	—	(32)	—	(32)
Segment EBITDA	$ 13,309	$ 805	$ (712)	$ (542)	$ 12,860
Total Segment Assets	$ 33,908	$ 20,189	$ 29,728	$ 37,872	$ 121,697
Segment Goodwill	$ 22,991	—	$ 8,699	$ 7,890	$ 39,580
Expenditures for long lived assets	$ 1,480	$ 2,644	$ 956	$ 1,493	$ 6,573

	Year Ended December 31, 2002 (in thousands)				
	Test Preparation Services	K-12 Services	Admission Services	Corporate	Total
Revenue	$ 67,930	$ 10,066	$ 11,240	—	$ 89,236
Operating Expenses (including depreciation and amortization)	$ 37,250	$ 11,916	$ 14,956	$ 1,704	$ 65,826
Segment operating income (loss)	12,163	(5,382)	(6,604)	(1,704)	(1,527)
Depreciation & Amortization	1,804	1,262	2,136	1,067	6,269
Other	—	—	(122)	—	(122)
Segment EBITDA	$ 13,967	$ (4,120)	$ (4,590)	$ (637)	$ 4,620
Total Segment Assets	$ 32,565	$ 12,740	$ 26,611	$ 40,200	$ 112,116
Segment Goodwill	$ 21,861	—	$ 8,406	$ 7,890	$ 38,157
Expenditures for long lived assets	$ 2,169	$ 1,673	$ 1,288	$ 2,828	$ 7,958

Reconciliation of operating income (loss) to net income (loss)

	Years Ended December 31, 2004	2003	2002
Total income (loss) for reportable segments	$ (13,448)	$ 6,855	$ (1,527)
Unallocated amounts:			
Interest expense	(693)	(607)	(624)
Other income	435	1,217	325
(Provision) benefit for income taxes	(16,707)	(3,156)	736
Net income (loss)	$ (30,413)	$ 4,309	$ (1,090)

14. Quarterly Results of Operations (Unaudited)

The following table presents unaudited statement of operations data for each of the eight quarters in the two-year period ended December 31, 2004. This information has been derived from the Company's historical consolidated financial statements and should be read in conjunction with the Company's historical consolidated financial statements and related notes appearing in this Annual Report on Form 10-K.

	Quarter Ended							
	Mar. 31, 2004	June 30, 2004	Sept. 30, 2004	Dec. 31, 2004	Mar. 31, 2003	June 30, 2003	Sept. 30, 2003	Dec. 31, 2003
	(in thousands, except per share data)							
Revenue								
Test Preparation Services	$ 18,830	$ 18,163	$ 24,185	$ 13,566	$ 16,030	$ 16,448	$ 25,045	14,196
K-12 Services	6,283	7,697	2,752	11,225	2,990	5,124	3,959	9,452
Admissions Services	2,834	2,587	2,665	2,998	2,674	2,123	3,000	3.421
Total revenue	27,947	28,447	29,602	27,789	21,694	23,695	32,004	27,069
Cost of revenue								
Test Preparation Services	5,820	5,313	7,316	5,135	4,292	5,278	6,637	4,602
K-12 Services	3,664	3,005	2,711	4,304	1,211	1,445	1,871	3,801
Admissions Services	596	557	1,161	1,071	908	470	812	646
Total cost of revenue	10,080	8,875	11,188	10,510	6,411	7,193	9,320	9,049
Gross profit	17,867	19,572	18,414	17,279	15,283	16,502	22,684	18,020
Operating expenses								
Selling, general and administrative	19,003	18,600	19,161	21,617	17,260	15,821	17,341	15,212
Impairment of goodwill	—	—	—	8,199	—	—	—	—
Total operating expenses	19,003	18,600	19,161	29,816	17,260	15,821	17,341	15,212
Income (loss) from operations	(1,136)	972	(747)	(12,537)	(1,977)	681	5,343	2,808
Net income (loss) attributed to common stockholders	$ (706)	$ 438	$ (618)	$ (29,955)	$ (1,203)	$ 299	$ 3,071	$ 2,142
Basic income (loss) per share	$ (0.03)	$ 0.02	$ (0.02)	$ (1.09)	$ (0.04)	$ 0.01	$ 0.11	$ 0.08
Diluted income (loss) per share	$ (0.03)	$ 0.02	$ (0.02)	$ (1.09)	$ (0.04)	$ 0.01	$ 0.11	$ 0.08
Weighted average shares used in								

computing net income (loss) per share								
Basic	27,391	27,430	27,497	27,559	27,272	27,282	27,317	27,358
Diluted	27,391	28,014	27,497	27,559	27,272	27,425	27,527	27,661

15. Earnings (Loss) Per Share

The following table sets forth the denominators used in computing basic and diluted earnings (loss) per common share for the periods indicated:

	Years Ended December 31,		
	2004	2003	2002
	(in thousands)		
Weighted average common shares outstanding			
Basic	27,468	27,306	27,239
Net effect of dilutive stock options-based on the treasury stock method	—	152	—
Other	—	9	—
Diluted	27,468	27,467	27,239

For the year ended December 31, 2004, the following were excluded from the computation of diluted earnings per common share because of their antidilutive effect: 577,961 Series B-1 Preferred Shares, 230,215 stock options, and 9 of other. For the year ended December 31, 2002, 135,916 stock options were excluded from the computation of diluted earnings per common share due to their antidilutive effect.

Report of Independent Auditors

To the Board of Directors and Stockholders of
The Princeton Review, Inc. and Subsidiaries

We have audited the accompanying consolidated balance sheets of The Princeton Review, Inc. and Subsidiaries (the "Company") as of December 31, 2003 and 2002, and the related consolidated statements of operations, stockholders' equity (deficit) and redeemable stock and cash flows for each of the three years in the period ended December 31, 2003. Our audits also included the financial statement schedule listed in the Index at Item 15(a). These financial statements and schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and schedule based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of The Princeton Review, Inc. and Subsidiaries as of December 31, 2003 and 2002 and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 2003 in conformity with accounting principles generally accepted in the United States. Also, in our opinion the related financial statement schedule, when considered in relation to the basic financial statements taken as a whole, presents fairly, in all material respects, the information set forth herein.

/s/ ERNST & YOUNG LLP

New York, New York
February 27, 2004

THE PRINCETON REVIEW, INC. AND SUBSIDIARIES

Consolidated Balance Sheets

	December 31, 2003	December 31, 2002
	(in thousands, except share data)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 13,937	$ 11,963
Accounts receivable, net of allowance of $302 in 2003 and $527 in 2002	17,394	11,301
Accounts receivable-related parties	2,822	2,304
Notes receivable	—	717
Other receivables ($1,017 in 2003 and $1,255 in 2002 from related parties)	1,045	1,273
Prepaid expenses	2,028	1,238
Securities, available for sale	8	31
Other assets	3,331	1,954
Total current assets	40,565	30,781
Furniture, fixtures, equipment and software development, net	11,808	11,353
Franchise costs, net of accumulated amortization of $175 in 2003 and $139 in 2002	107	144
Publishing rights, net of accumulated amortization of $611 in 2003 and $538 in 2002	1,150	1,223
Deferred income taxes	15,812	18,599
Investment in affiliates	387	420
Territorial marketing rights	1,481	1,481
Goodwill	39,580	38,157
Other assets ($1,196 in 2003 and $1,117 in 2002 of loans to officers)	10,807	9,958
Total assets	$121,697	$112,116
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 10,575	$ 6,284
Accrued expenses ($195 in 2003 and $156 in 2002 for related parties)	5,522	4,857
Current maturities of long-term debt	1,318	1,866
Deferred income	12,879	12,579
Book advances ($48 in 2003 and $34 in 2002 from related parties)	48	610
Total current liabilities	30,342	26,196
Deferred rent	1,178	966
Long-term debt	5,710	5,656
Stockholders' equity:		
Preferred stock, $.01 par value; 5,000,000 shares authorized; none issued and outstanding at December 31, 2003 and 2002	—	—
Common stock, $.01 par value; 100,000,000 shares authorized; 27,385,273 and 27,261,085 issued and outstanding at December 31, 2003 and 2002, respectively	274	273
Additional paid-in capital	114,829	113,972
Accumulated deficit	(30,261)	(34,570)
Accumulated other comprehensive loss	(375)	(377)
Total stockholders equity	84,467	79,298
Total liabilities and stockholders' equity	$121,697	$112,116

See accompanying notes.

THE PRINCETON REVIEW, INC. AND SUBSIDIARIES

Consolidated Statements of Operations

	Year Ended December 31,		
	2003	2002	2001
	(in thousands, except per share data)		
Revenue			
Test Preparation Services	$ 71,719	$67,930	$ 55,340
K-12 Services	21,525	10,066	6,885
Admissions Services	11,218	11,240	6,890
Total revenue	104,462	89,236	69,115
Cost of revenue			
Test Preparation Services	21,906	19,645	17,608
K-12 Services	8,328	3,533	2,482
Admissions Services	2,836	2,888	1,653
Total cost of revenue	33,070	26,066	21,743
Gross profit	71,392	63,170	47,372
Operating expenses			
Selling, general and administrative	64,537	64,353	60,993
Loss on early extinguishment of debt	—	—	3,130
Impairment of investment	—	344	—
Total operating expenses	64,537	64,697	64,123
Income (loss) from operations	6,855	(1,527)	(16,751)
Interest expense	(607)	(624)	(2,043)
Other income	1,217	325	536
Income (loss) before (provision) benefit for income taxes	7,465	(1,826)	(18,258)
(Provision) benefit for income taxes	(3,156)	736	7,924
Net income (loss)	4,309	(1,090)	(10,334)
Accreted dividends on Series A redeemable preferred stock	—	—	(2,309)
Accreted dividends on Class B non-voting common stock	—	—	(1,956)
Net income (loss) attributed to common stockholders	$ 4,309	$ (1,090)	$(14,599)
Basic income (loss) per share	$ 0.16	$ (0.04)	$ (0.68)
Diluted income (loss) per share	$ 0.16	$ (0.04)	$ (0.68)
Weighted average shares used in computing net income (loss) per share			
Basic	27,306	27,239	21,383
Diluted	27,467	27,239	21,383

See accompanying notes.

THE PRINCETON REVIEW, INC. AND SUBSIDIARIES

Consolidated Statements of Stockholders' Equity (Deficit) and Redeemable Stock
(in thousands)

	Redeemable Stock				Stockholders' Equity (Deficit)								
	Series A Redeemable Convertible Preferred Stock		Class B Redeemable Non-voting Common Stock		Capital Stock: Class A Common Stock		Capital Stock: Common Stock		Additional Paid-In Capital	Accumulated Deficit	Accumulated Other Compre-hensive Loss	Deferred Compen-sation	Total Stockholders Equity/ (Deficit)
	Shares	Amount	Shares	Amount	Shares	Amount	Shares	Amount					
Balance at December 31, 2000	3,749	29,201	2,737	20,571	12,562	126	—	—	1,907	(18,881)	2,113	(101)	(14,836)
Accretion of issuance costs related to Series A redeemable preferred stock	—	160	—	—	—	—	—	—	(160)	—	—	—	(160)
Accreted dividends on Series A redeemable preferred stock	—	2,309	—	—	—	—	—	—	—	(2,309)	—	—	(2,309)
Conversion of Class A common to common stock resulting from initial public offering	—	—	—	—	(12,562)	(126)	12,562	126	—	—	—	—	—
Conversion of Series A redeemable preferred to common stock resulting from initial public offering	(3,749)	(31,670)	—	—	—	—	5,342	53	31,617	—	—	—	31,670
Accreted dividends on Class B non-voting common stock	—	—	—	1,956	—	—	—	—	—	(1,956)	—	—	(1,956)
Deferred compensation	—	—	—	59	—	—	—	—	81	—	—	101	182
Conversion of Class B common to common stock resulting from initial public offering	—	—	(2,737)	(22,586)	—	—	2,737	27	22,559	—	—	—	22,586
Net proceeds from sale of common stock resulting from initial public offering	—	—	—	—	—	—	5,400	54	51,806	—	—	—	51,860
Adjustment to warrants value resulting from initial public offering	—	—	—	—	—	—	—	—	(250)	—	—	—	(250)
Warrants issued in connection with legal settlement	—	—	—	—	—	—	—	—	300	—	—	—	300
Issuance of shares related to exercise of warrants	—	—	—	—	—	—	250	3	—	—	—	—	3
Exercise of stock options	—	—	—	—	—	—	9	—	25	—	—	—	25
Shares issued in connection with acquisition	—	—	—	—	—	—	875	9	5,206	—	—	—	5,215
Comprehensive loss	—	—	—	—	—	—	—	—	—	—	—	—	—
Net loss	—	—	—	—	—	—	—	—	—	(10334)	—	—	(10,334)
Foreign currency gain/loss	—	—	—	—	—	—	—	—	—	—	(208)	—	(208)
Unrealized gain on securities, net of applicable income tax expense of $418	—	—	—	—	—	—	—	—	—	—	(1,555)	—	(1,555)
Comprehensive loss	—	—	—	—	—	—	—	—	—	—	—	—	(12,097)
Balance at December 31, 2001	—	—	—	—	—	—	27,175	272	113,091	(33,480)	350	—	80,233
Exercise of stock options	—	—	—	—	—	—	40	—	266	—	—	—	266
Stock based compensation	—	—	—	—	—	—	—	—	256	—	—	—	256
Shares issued in connection with acquisition	—	—	—	—	—	—	46	1	359	—	—	—	360
Comprehensive loss	—	—	—	—	—	—	—	—	—	—	—	—	—
Net loss	—	—	—	—	—	—	—	—	—	(1,090)	—	—	(1,090)
Foreign Currency gain/loss	—	—	—	—	—	—	—	—	—	—	(176)	—	(176)
Unrealized gain on securities, net of applicable income tax expense of $420	—	—	—	—	—	—	—	—	—	—	(551)	—	(551)
Comprehensive loss	—	—	—	—	—	—	—	—	—	—	—	—	(1,817)
Balance at December 31, 2002	—	—	—	—	—	$ —	27,261	$273	$113,972	$(34,570)	$ (377)	$ —	$ 79,298
Exercise of stock options, including income tax benefit of $125	—	—	—	—	—	—	124	1	706	—	—	—	707
Stock based compensation	—	—	—	—	—	—	—	—	151	—	—	—	151
Comprehensive income	—	—	—	—	—	—	—	—	—	—	—	—	—
Net Income	—	—	—	—	—	—	—	—	—	4,309	—	—	4,309
Foreign currency gain/loss	—	—	—	—	—	—	—	—	—	—	15	—	15
Unrealized gain on securities, net of applicable income tax expense of $10	—	—	—	—	—	—	—	—	—	—	(13)	—	(13)
Comprehensive income	—	—	—	—	—	—	—	—	—	—	—	—	4,311
Balance at December 31, 2003	—	—	—	—	—	$ —	27,385	$274	$114,829	$(30,261)	$ (375)	$ —	$ 84,467

See accompanying notes.

THE PRINCETON REVIEW, INC. AND SUBSIDIARIES

Consolidated Statements of Cash Flows

	Years Ended December 31,		
	2003	2002	2001
		(in thousands)	
Cash flows from operating activities:			
Net income (loss)	$ 4,309	$(1,090)	$(10,334)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:			
Depreciation	1,664	1,801	1,233
Amortization	4,373	4,468	5,246
Impairment of investment	—	344	—
Noncash interest expense	54	—	602
Loss on early extinquishment of debt	—	—	3,130
Bad debt expense	380	655	(82)
Gain on disposal of fixed assets	2	126	—
Deferred income taxes	2,851	(736)	(8,221)
Income tax benefit on stock options exercised	125	—	—
Deferred rent	211	101	381
Stock based compensation	151	256	241
Net change in operating assets and liabilities:			
Accounts receivable	(6,373)	(6,349)	2,634
Accounts receivable—related parties	(518)	(998)	1,139
Other receivables	(11)	107	100
Other receivables—related parties	238	(594)	(196)
Prepaid expenses	(764)	(43)	(46)
Other assets	(1,879)	256	296
Accounts payable	4,295	(1,220)	4,422
Accrued expenses	479	(659)	(3,676)
Accrued expenses—related parties	39	22	—
Deferred income	86	4,312	(2,475)
Book advances	(575)	(113)	(1,127)
Book advances—related parties	14	(79)	(209)
Net cash provided by (used in) operating activities	9,151	567	(6,942)
Cash flows from investing activities:			
Additions to furniture, fixtures, equipment and software development	(4,272)	(6,107)	(3,695)
Investment in affiliates	—	(270)	(130)
Purchase of franchises and other businesses, net of cash acquired	(568)	(1,393)	(16,697)
Stockholders loan	—	(400)	(615)
Notes receivable	717	1,123	(1,840)
Additions to capitalized development costs and other assets	(1,706)	(1,851)	(1,036)
Net cash used in investing activities	(5,829)	(8,898)	(24,013)
Cash flows from financing activites:			
Borrowings under line of credit	—	—	24,691
Repayment of line of credit	—	—	(29,464)
Repayment term loan, net	—	(50)	(10)
Capital leases payments	(274)	(204)	(546)
Notes payable related to acquisitions	(1,656)	(1,653)	—
Proceeds from sale of common stock in initial public offering, net	—	—	53,320
Proceeds from exercise of options	582	266	25
Net cash (used in) provided by financing activities	(1,348)	(1,641)	48,016
Net increase (decrease) in cash and cash equivalents	1,974	(9,972)	17,061
Cash and cash equivalents, beginning of period	11,963	21,935	4,874
Cash and cash equivalents, end of period	$13,937	$11,963	$ 21,935
Supplemental disclosures of cash flow information and noncash investing activities			
Cash paid during the year for:			
Interest	$ 462	$ 629	$ 1,909
State and local income taxes	$ 408	$ 237	$ 136
Equipment acquired through capital leases	$ 595	$ 229	$ 241

See accompanying notes.

THE PRINCETON REVIEW, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

1. Nature of Business and Significant Accounting Policies

Business

The Princeton Review, Inc. and its wholly owned subsidiaries, Princeton Review Management, LLC, Princeton Review Publishing, LLC, Princeton Review Products, LLC, Princeton Review Operations, LLC, Princeton Review Carolinas, LLC and The Princeton Review of Canada Inc, as well as the Company's national advertising fund (together, the "Company"), are engaged in the business of providing courses that prepare students for college, graduate school and other admissions tests. The Company, through Princeton Review Operations, LLC, provides these courses in various locations throughout the United States and Canada and over the Internet. As of December 31, 2003, the Company had eight franchisees operating approximately 18 offices under the Princeton Review name in the United States and approximately 25 offices abroad operated by franchisees in 14 countries. The Company also sells support materials and equipment to its franchisees, authors content for various books and software products published by third parties, sells web-based products to higher education institutions, operates a Web site providing education-related content and provides a number of services to K-12 schools and school districts to help them measurably improve academic performance.

Principles of Consolidation

The accompanying consolidated financial statements include the accounts of The Princeton Review, Inc. and its wholly owned subsidiaries. All significant intercompany transactions and balances are eliminated in consolidation.

Cash and Cash Equivalents

As of December 31, 2003 and 2002, cash and cash equivalents consist of investments in securities issued or guaranteed by the U.S. government, its agencies or instrumentalities, which have average maturities of 90 days or less at the date of purchase. Approximately 85% and 83% of the Company's cash and cash equivalents at December 31, 2003 and 2002, respectively, were on deposit at one financial institution.

Inventories

Inventories consist of program support equipment, course materials and supplies. All inventories are valued at the lower of cost (first-in, first-out basis) or market.

Furniture, Fixtures and Equipment

Furniture, fixtures and equipment are stated at cost less accumulated depreciation and amortization. Depreciation is computed using straight-line method over the estimated useful lives of the assets principally ranging from three to seven years. Leasehold improvements are amortized using the straight-line method over the lesser of the lease term or its estimated economic useful life.

Software and Web site Development

The Company accounts for internal use software development in accordance with the provisions of the American Institute of Certified Public Accountants Statement of Position ("SOP") 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use* and Emerging Issues Task Force ("EITF") 00-2, *Accounting for Web site Development Costs.*

For the years ended December 31, 2003, 2002 and 2001, the Company expensed approximately $2.3 million, $3.6 million and $1.3 million, respectively, of product development costs that were incurred in the preliminary project stage under SOP 98-1. For the years ended December 31, 2003 and 2002, the

Company capitalized approximately $2.8 million and $2.2 million, respectively, in product and website development costs under SOP 98-1 and EITF 00-2. For the years ended December 31, 2003, 2002 and 2001, the Company recorded related amortization expense of approximately $2.4 million, $2.6 million and $2.4 million, respectively. As of December 31, 2003 and 2002, the net book value of these capitalized product and web site development costs were $5.0 million, and $4.5 million, respectively. These capitalized costs are amortized using the straight-line method over the estimated useful life of the assets ranging from 12 to 60 months.

Franchise Costs

The cost of franchise rights purchased by the Company from third parties is amortized using the straight-line method over the remaining useful life of the franchise agreement.

Publishing Rights

Publishing rights consist of amounts paid in 1995 to certain co-authors to buy out their rights to future royalties on certain books. Such amounts are being amortized on a straight-line basis over 25 years.

Capitalized Course Costs

Capitalized course costs, which include courses and questions developed for Homeroom, are included in other assets and consist of amounts paid to consultants or employees specifically hired for the development or substantial revision of courses and their related materials. Amortization of these capitalized course costs commences with the realization of course revenues. The amortization periods range from one to seven years.

Goodwill and Territorial Marketing Rights

Goodwill represents the excess purchase price of acquired businesses over the estimated fair value of net assets acquired. Territorial marketing rights represent rights contributed by our independent franchisees to Princeton Review Publishing, LLC in 1995 in exchange for membership units of Princeton Review Publishing LLC to allow the marketing of the Company's products on a contractually agreed-upon basis within the franchisee territories. Without these rights, the Company would be prohibited from selling its products in these territories due to the exclusivity granted to the franchisees within their territories.

In conjunction with the adoption of Statements of Financial Accounting Standards No. 142, as of January 1, 2002, the Company's goodwill and intangible assets including territorial marketing rights that are deemed to have indefinite lives are no longer amortized but are subject to annual impairment tests. Accumulated amortization at the time of adoption was $2.3 million. Other intangible assets are amortized over their useful lives and are evaluated for impairment whenever events or circumstances indicate that carrying amounts may not be recoverable through future undiscounted cash flows, excluding interest costs. If tests or circumstances suggest that the Company's intangible assets are impaired, the Company assesses the fair value of the intangible assets and reduces them to an amount that results in book value approximating fair value. Had the Company adopted SFAS No. 142 on January 1, 2001 and ceased to amortize goodwill and territorial marketing rights at such date, the Company's historical net loss and basic and diluted net loss per share would have been as follows:

	Year Ended December 31, 2001 (in thousands, except per share data)
Reported net loss	(14,599)
Goodwill amortization, net of tax	806
Territorial marketing rights amortization, net of tax	66
Adjusted net loss	$(13,727)
Reported basic and diluted net loss per share	$ (0.68)
Goodwill amortization	0.04
Territorial marketing rights amortization	0.00
Adjusted basic and diluted net loss per share	$ (0.64)

The following table summarizes the change in the carrying amount of segment goodwill for the periods indicated:

	Test Preparation Services	K-12 Services	Admissions Services	Other	Total
			(in thousands)		
Balance as of December 31, 2001	$20,791	—	$7,206	$7,890	$35,887
Net change from acquisitions	1,069	—	1,200	—	2,269
Other	1	—	—	—	1
Balance as of December 31, 2002	21,861	—	8,406	7,890	38,157
Net change from acquisitions	1,123	—	293	—	1,416
Other	7	—	—	—	7
Balance as of December 31, 2003	$22,991	—	$8,699	$7,890	$39,580

Investments in Affiliates

The Company values its investments in affiliate companies in which it has a less than 50% ownership interest and can exercise significant influence using the equity method of accounting. Ownership interests in such investments are approximately 20%. Investments in affiliate companies in which the Company has a less than 20% ownership interest and does not have the ability to exercise significant influence are accounted for using the cost method of accounting.

Deferred Income

Deferred income represents tuition and customer deposits (which are refundable prior to the commencement of the program), college marketing fees and subscription services, professional development fees and fees for printed materials. Tuition is applied to income ratably over the periods in which it is earned, generally the term of the program. College marketing fees and subscription fees are applied to income ratably over the life of the agreements, which range from 12 to 36 months. Fees for professional development and printed materials are recognized as the services and products are delivered.

Revenue Recognition

The Company recognizes revenue from the sale of products and services as follows:

Course and Tutoring Income

Tuition and tutoring fees are paid to the Company and recognized over the life of the course.

THE PRINCETON REVIEW, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements—(Continued)

Book, Software and Publication Income and Expenses

The Company recognizes revenue from both performance-based fees such as marketing fees and royalties and delivery-based fees such as advances, copy editing fees, workbook development and test booklet fees and books sold directly to schools. Performance-based fees, which represent royalties on books and software sold, are recognized when sales reports are received from the publishers. Delivery-based fees are recognized upon the completion and acceptance of the product by the publishers and/or customers. Until such time, all costs and revenues related to such delivery-based fees are deferred. Book advances are recorded as liabilities and deferred book expenses are included in other current assets.

Royalty Service Fees

As consideration of the rights and entitlements granted under franchise agreements, which entitle the franchisees to provide test preparation services utilizing the Princeton Review method in their licensed territories, the franchisees are required to pay to the Company a monthly royalty service fee equal to 8% of the franchise's gross receipts collected during the preceding month. In addition, these fees include a per student fee charged to the Company's franchisees for use by their students of the Company's supplemental online course tools. The Company's franchisees' contributions to the advertising fund are also recognized by the Company as royalty revenue (See Note 8). Under the terms of the franchise agreements, the Company has the right to perform audits of royalty service fees reported by the franchisees. Any differences resulting from an audit, including related interest and penalties, if any, are recorded upon the completion of the audit when such amounts are determinable.

Course Materials and Other Products

The Company recognizes revenue from the sale of course materials and other products to the independently owned franchises upon shipment.

College Marketing and Subscription Fees

The Company recognizes revenue from subscription fees for web-based services over the life of the contract, which is typically one year in duration.

Transaction Processing Fees

The Company recognizes revenue from transaction processing fees, such as web-based application fees, as the transactions are completed.

Other Income

Other income consists of miscellaneous fees for other services provided to third parties primarily for authoring questions, advertising, training and professional development fees, which are recognized as the products or services are delivered. Also included in Other Income are college marketing fees which are recognized ratably over the period in which the marketing services are provided, which is typically one year.

Multiple-deliverable contracts

Certain of the Company's customer contracts represent multiple-element arrangements, which may include several of the Company's products and services. Multiple-element arrangements are assessed to determine whether they can be separated into more than one unit of accounting. A multiple-element arrangement is separated into more than one unit of accounting if all of the criteria in EITF 00-21 are met. If there is objective and reliable evidence of fair value for all units of accounting in an arrangement, the arrangement consideration is allocated to the separate units of accounting based on each unit's relative fair value and the revenue policies described above are then applied to each unit of accounting.

THE PRINCETON REVIEW, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements—(Continued)

The following table summarizes the Company's revenue and cost of revenue for the years ended December 31, 2003, 2002 and 2001:

	Course Revenues	Royalty Service Fees	Book, Software and Publication Income	Web Based Subscription and Processing Fees	Other Income	Total
			(in thousands)			
Year Ended December 31, 2003						
Revenue						
Test Preparation Services	$65,223	$4,156	$ 2,218	—	$ 122	$ 71,719
K-12 Services	2,013	—	11,703	$ 3,437	4,372	21,525
Admissions Services	—	—	982	9,436	800	11,218
Total	$67,236	$4,156	$14,903	$12,873	$5,294	$104,462
Cost of Revenue						
Test Preparation Services	$21,174	—	$ 732	—	—	$ 21,906
K-12 Services	783	—	2,749	$ 856	$3,940	8,328
Admissions Services	—	—	831	2,005	—	2,836
Total	$21,957	—	$ 4,312	$ 2,861	$3,940	$ 33,070
Year Ended December 31, 2002						
Revenue						
Test Preparation Services	$60,946	$4,256	$ 1,995	—	$ 733	$ 67,930
K-12 Services	769	—	6,773	$ 1,637	887	10,066
Admissions Services	—	—	848	8,665	1,727	11,240
Total	$61,715	$4,256	$ 9,616	$10,302	$3,347	$ 89,236
Cost of Revenue						
Test Preparation Services	$18,891	—	$ 754	—	—	$ 19,645
K-12 Services	659	—	1,595	$ 673	$ 606	3,533
Admissions Services	—	—	485	2,403	—	2,888
Total	$19,550	—	$ 2,834	$ 3,076	$ 606	$ 26,066
Year Ended December 31, 2001						
Revenue						
Test Preparation Services	$49,853	$3,262	$ 1,404	—	$ 821	$ 55,340
K-12 Services	—	—	5,874	$ 565	446	6,885
Admissions Services	—	—	689	4,622	1,579	6,890
Total	$49,853	$3,262	$ 7,967	$ 5,187	$2,846	$ 69,115
Cost of Revenue						
Test Preparation Services	$17,019	—	$ 589	—	—	$ 17,608
K-12 Services	—	—	1,848	$ 498	$ 136	2,482
Admissions Services	—	—	144	1,007	502	1,653
Total	$17,019	—	$ 2,581	$ 1,505	$ 638	$ 21,743

Foreign Currency Translation

Balance sheet accounts of the Company's Canadian subsidiary are translated using year-end exchange rates. Statement of operations accounts are translated at monthly average exchange rates. The resulting translation adjustment is recorded as a separate component of stockholders' equity. Foreign exchange gains and losses for all the years presented were not significant. The accumulated balance as a component of comprehensive income was approximately $359,000 and $373,000 at December 31, 2003 and 2002, respectively.